

4TH QUARTER, 2012

COMMUNITY ASSOCIATION LIVING

THE OFFICIAL JOURNAL OF COMMUNITY ASSOCIATIONS INSTITUTE - AUSTIN CHAPTER

FINANCE & INSURANCE

THE INSURANCE PUZZLE
WHAT BOARDS MUST DO AND MUST AVOID

- Also in this issue ...*
- Preventing Fraud and Embezzlement
 - When Reserve Funds Are Not Enough
 - Winterizing Your Property
 - Pitfalls of Insurance Coverage
 - Common Sense Security for Your Home
 - Enhancing Your Community with the New Technology
 - Protecting Your Green Growing Assets

... and more!



THE COMMUNITY ASSOCIATION INSURANCE PUZZLE

WHAT THE BOARD MUST DO AND MUST AVOID TO ASSEMBLE THE PUZZLE

by Joel W. Meskin, CIRMS

A key obligation of the association board is to protect the assets of the association. One of the primary elements of this responsibility is insurance, but many volunteer board members have limited experience with insurance. They're only familiar with purchasing personal auto, home and life insurance. Most know the limits and the price, but few really take the opportunity to understand coverage until they have an uncovered loss. Many are swayed in their insurance shopping because they are "in good hands" or are protected by "good neighbors".

Once volunteer board members are elected, however, many become intimidated by insurance. This article will help demystify insurance and provide a better understanding of the association's needs and provide some tools that are useful to use to carry out this obligation.

WHY A COMMUNITY ASSOCIATION?

Most individuals chose to live in a mandatory community association to protect their two greatest assets, their home and their lifestyle. Homeowners believe that the community association can better protect these assets than they could do as individuals.

How Does the Association Protect Assets?

First, the association is normally a legal entity. Second, it must (if a legal entity, and should regardless) have bylaws which serve as the operating manual for the association¹. Third, the declaration of covenants, conditions and restrictions set forth the rules and restrictions created to preserve the association's assets. Next, the association needs a management team which in the normal course is a board of directors and finally, the association needs the funds to enable the board to manage.

How Does the Board Determine the Cost of Management?

This is done by the development of a budget. The first step should and often is a reserve study which is the cornerstone to an association's preservation. This is the heart through which the life blood of the association

1 Most states require HOAs to be incorporated, but check your state laws to confirm.

pumps. Some associations do not have a reserve study contending they are too small or cannot afford it, and others have other infrastructures set in place which may incorporate the benefits that a reserve study would provide. The key is to know what exists, what is necessary to maintain it and how much that will cost. At the end of the day, association members need to plan in order to avoid surprises.

How Does the Association Cover Non-Budgeted Costs?

There are really only two ways to cover non-budgeted costs. The budgeted costs are funded by general fees and assessments. No matter what association you live in and no matter how well you manage the association, "stuff" happens and non-budgeted costs and expenses will arise. This will manifest either as a repair or improvement that is required before its expected time or the result of a loss or casualty. These unexpected costs are covered either by insurance (if insurable) or a special assessment.

WHAT IS THE BOARD'S OBLIGATION?

In most states, the association has a "fiduciary" obligation and in other states, some statutes may only place a duty of ordinary care on the board. The fiduciary duty includes the duty of loyalty and the duty of care. The duty of loyalty requires that the board put the interests of the association above their own and disclose and avoid any conflicts of interest.

The duty of care requires the exercise of the care, diligence and skill that an ordinary, prudent person would exhibit under similar circumstances. This means, at a minimum, paying attention to the substantive matters brought before the board, attending meetings,

asking questions, challenging assumptions, following up on issues that may not have been resolved, consulting with experts if needed, reading and understanding materials and reports given to the board.

Accordingly, the board cannot delegate the task of obtaining the appropriate insurance for the association.

TO UNDERSTAND INSURANCE IS TO KNOW CLAIMS

To understand what types of insurance an association needs requires the board to know what type of claims, losses, accidents and exposures that an association may encounter. To know the nature of community association risk is key to exercising its obligation.

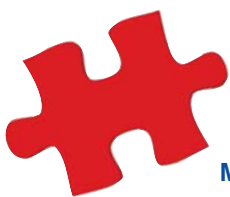
Some common claims include:

- Election dispute claim
- Economic loss claim for wrongful eviction of unit owner's tenant
- Demand by unit owner to compel association to purchase flood insurance
- Building fire due to a barbeque grill on a balcony
- Discrimination claims
- Bodily injury and medical costs for slip and fall on the common area
- Property damage claim due to the improper calibration of the security gate
- Challenge to Architectural Review Committee decision
- Challenge to board rule requiring dog owners submit their pet's DNA
- Emotional distress damages due to discriminatory application of rules
- Water damage claim from faulty washing machine hoses
- City demand to remove diseased trees that the association's arborist claim are healthy

WHAT DOES IT MEAN FOR THE BOARD TO SHOP FOR INSURANCE?

First, what it does not mean to shop insurance. Recently, while I was at a local association trade show, I asked a board president if he would like to discuss insurance. He said no, because that is what they pay the community management to do. I doubt he will give that answer again.

Delegation of the insurance responsibility to a non-insurance professional may itself be a breach of the board's duty. Yes, the board can consult experts, but it cannot delegate the task. It should be noted that most management agreements require that the association indemnify the management company if it is sued. Therefore, if the management company, which is typically not a licensed insurance professional, makes a mistake, it is not accountable to the association. For management companies, they should not be assuming that responsibility as their errors and omissions policy in most cases expressly excludes claims arising out of insurance issues.



PUZZLE PIECE No. 1:

MUST DO: Find an Insurance Professional that Specializes in Community Associations.

Most people do not hire a real estate attorney to handle a medical malpractice case or hire a cardiologist to perform knee surgery. Why then would a board hire an insurance professional who does not specialize in community association insurance? Unfortunately, there is no short cut and if the board members do not want to do their homework, they should resign from the

board. What they need to do is find an insurance professional who has a proven track record. Get responses to the following in writing, the hesitation to do so should raise a flag.

- How many associations have they insured?
- How many management companies do they work with?
- Do they participate in CAI?
- Have they asked to review the governing documents?
- Have they asked to review your reserve study?
- Have they asked about appraisals?
- Have they explained how each policy works?
- Have they requested to personally meet with the board?
- Have they offered to bring in other insurance specialists?

MUST AVOID: Point of Sale Price

Community associations are budget-driven entities. However, boards should not look at the bottom line while wearing blinders. "Stuff" happens and there are casualties, hazards and accidents that happen that a reasonable person cannot always anticipate. This is why the association purchases insurance. In the insurance world, like in many purchasing opportunities, you get what you pay for; this is not an absolute, but a rule of thumb. Insurance carriers do not give you something for free. Accordingly, if one policy is materially less, there is a reason.

I once received a phone call from an association president, who was also a very successful attorney. She said an insurance agent told the board that he would give them higher limits for a lower premium. That was in fact true. Unfortunately, the higher limits came with coverage restrictions. The good news was they saved \$400. The bad news was they incurred over \$100,000

in defense costs for claims the new policy did not cover.

PUZZLE PIECE No. 2

MUST DO: Understand The Puzzle



The board must endeavor to understand the association's insurance requirements.

First, the association must know what types of insurance and limits are required by the governing documents? Second, are there statutory requirements that differ from the governing documents? Third, has the board done an audit of the common elements of the association knowing what needs to be insured and what does not? Fourth, has the board done an audit on the potential liability exposure of the association? Fifth, do you have current valuations of the common elements? Finally, are any association members doing things that increase potential liability for the association? Such as Neighborhood Watch, swimming lessons in the community pool or pee wee football practice on common elements.

MUST AVOID: Inappropriate Delegation

The board must not delegate the insurance responsibility to anyone else. Yes, the board can delegate some research, the setting up of meetings and clerical issues, but it cannot delegate its duty to review, ask questions and due diligence necessary to understand insurance.

THE INSURANCE PUZZLE

The board must review the entire insurance puzzle, there is no short cut. The only short cut is the use of a community association insurance special-

ist. The details of the puzzle will not be explored in depth in this article, but the following are the general types of insurance that may or may not be required for your association. Each puzzle piece has key corresponding questions.

- Property Coverage
- General Liability Coverage
- Directors & Officers Liability/Employment Liability Insurance
- Fidelity/Crime Insurance
- Umbrella Liability Insurance
- Workers Compensation
- Windstorm/Earthquake/Flood
- Fiduciary Coverage\Unit Owner Insurance Needs
 - Single Family Homeowner policy
 - Unit Owner HO-6 policy

CONCLUSION

There is no short cut. Do your homework.



Joel W. Meskin, Esq., is Vice President - Community Association Insurance & Risk Management, McGowan & Company, Inc., and is the former Senior Vice President, Ian H. Graham Insurance. He is an attorney who spent 15 years specializing in insurance coverage and related litigation. Joel is also an insurance broker and has obtained the designation of a Community Insurance & Risk Management Specialist (“CIRMS”) by Community Associations Institute and is a member of CAI’s Insurance Networking committee. You may reach Joel at jmeskin@mcgowaninsurance.com (440) 333-6300

